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Summary of the survey of economic and social developments in the Economic and Social Commission for Western Asia region, 2005-2006

Summary

The economies of member countries of the Economic and Social Commission for Western Asia (ESCWA) continued to grow for the third straight year after two decades of stagnation. This growth, however, is relatively jobless and dependent on one unsustainable trend: a huge surge in the price of oil. Sooner or later, the trend will end, possibly abruptly, and when that happens the drop may be even more acute because resources are being intermediated by speculation on a poorly regulated regional asset market. Had the bursting of the regional stock market bubble coincided with even a moderate drop in oil prices, the negative impact on economic growth would have been severe. Using windfall oil rents to speculate on slowly expanding assets doubly exposes the region to more volatility. Instead of bubble-building in the regional stock markets (some doubling in value in less than a year) and capital diversion abroad, the current relative abundance of capital should offer ESCWA member countries a timely opportunity to implement some of the structural changes that are urgently needed to set the region on the path of rights-based development and employment-intensive growth free from the vacillations in the price of oil.

Failure to take advantage of the current oil boom and reinvest in the region will consign the present surge in rents to a time-bound gain in a way similar to what happened during the great oil booms of the 1970s. The ESCWA region will not be able to leave the lower, short-lived paths of growth and development for higher, sustainable paths if the Governments in the region continue to pursue traditional reforms concentrated solely on improving the business environment, while neglecting targeted public investment. A viable strategy of reform should recognize

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two essential points. First, sustainability of growth cannot be maintained without the effective participation of the citizenry. Reform in public institutions and policies should be carried out with the determined purpose of implementing a rights-based development strategy. Secondly, sustainable growth would be enhanced with the production of some public goods that no single country in the region is capable of producing optimally by itself. These goods have the characteristic of being regional goods, and their optimal production requires regional coordination and cooperation.

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I. Introduction

1. The *Survey of Economic and Social Developments in the ESCWA Region, 2005-2006* outlines a set of economic policy principles formulated to contribute to the design of human rights-based, pro-poor and employment-intensive development strategies in the region. The right to development, in line with the second preambular paragraph of the Declaration on the Right to Development, adopted by the General Assembly in its resolution 41/128 of 4 December 1986, may be defined as a "comprehensive economic, social, cultural and political process, which aims at the constant improvement of the well-being of the entire population and of all individuals on the basis of their active, free and meaningful participation in development and in the fair distribution of benefits resulting therefrom".*

2. These rights-oriented policy proposals are based on three propositions. First, poverty is the most important problem faced by the ESCWA member countries, and its elimination should be their Governments' main priority. This aim is not only significant in itself; it is also mandated by the United Nations through the Universal Declaration of Human Rights, the Declaration on the Right to Development and the Millennium Development Goals. Secondly, rapid and sustained growth, balance of payments equilibrium, inflation control, industrial development and other conventional parameters of economic "success" have limited value in themselves unless they become instruments for the elimination of mass poverty and the achievement of secure, sustainable, equitable and empowering human development in the ESCWA region. Thirdly, macroeconomic policy instruments can make an important contribution to eliminating mass poverty and to bridging the gaping gender divide.

3. From this rights-based, pro-poor viewpoint, the conventional economic strategies employed in the ESCWA region have been largely unsuccessful. The stabilization and structural adjustment policies implemented during the past 25 years have failed to trigger rapid economic growth and a sustained reduction of poverty. Unfortunately, these policies are not self-correcting, and their perceived failure often leads to the intensification of the ongoing structural adjustment programmes.

4. There is both the scope and the urgent need for a shift in economic policy strategies in order to achieve desirable human development goals in the ESCWA region. In this effort, employment creation is the critical link between economic growth and welfare improvement, and it offers an essential platform for the achievement of pro-poor outcomes. The policy principles outlined in this year's *Survey* will be sufficiently flexible to contribute, with suitable adaptation, to the achievement of these desirable outcomes in most countries in the ESCWA region, including the oil-rich, the more diversified and the very poor economies. The *Survey* suggests that this can be done through a combination of rapid, sustainable and employment-intensive growth, and the distribution of income and assets in a regionally designed development compact.

5. Traditionally, macroeconomic policy has been concerned primarily with ensuring macroeconomic stability, with growth and poverty reduction seen as derived goals. This approach has reached its limit. Rights-based poverty reduction

* See also the study on the current state of progress in the implementation of the right to development submitted by Arjun K. Sengupta, independent expert, to the Working Group on the Right to Development of the Commission on Human Rights (E/CN.4/1999/WG.18/2).

objectives should ground national economic policymaking, and play a central role in the selection of the development strategy of the ESCWA region. In line with this approach, the *Survey* examines the interaction between employment, poverty and economic policy, especially fiscal, financial, monetary and exchange rate policy, with the aim of developing the institutional means to generate more employment-intensive growth in ESCWA member States.

6. With unemployment holding steady at the 15 per cent mark after three successive years of cumulative steady growth of nearly 17 per cent, a rights-based development strategy has become not only worthwhile, but urgent. Given the extraordinarily long-entrenched patterns of inequality, in particular gender inequality, in most ESCWA member countries, it has been estimated that the region needs to create 35 million decent jobs during the next decade in order to meet its development targets. The achievement of this goal is complicated by the coexistence of complex patterns of high unemployment with labour export between countries in the ESCWA region, and between these countries and other regions of the world. It could be argued that several countries in the region are in an unemployment trap, which is perpetuated by an undesirable and ultimately risk-enhancing policy compact. Current policies tend to do little to address these urgent problems, are incompatible with the Millennium Development Goals, and militate against international human rights conventions.

7. The implementation of rights-based fiscal, financial, monetary and exchange-rate policies in the ESCWA region requires careful policy coordination at the national and regional levels. It also requires the subordination of these policies to a rights-based development compact and an industrial policy strategy aimed at relieving the supply constraints that currently preclude the welfare improvements rightly expected by the population. The current macroeconomic reform strategy adopted in several countries in the ESCWA region focuses on the adjustment of relative prices and the construction of the institutional edifice into which a thriving market economy is expected to grow, filling up the pre-existing spaces. Experiments have shown that this strategy is flawed because it is impossible to wish into existence an institutionally developed economy, and it is undesirable to attempt to impose economic structures from the outside that may not correspond to the demands, expectations and economic characteristics of the ESCWA region. The *Survey* concludes that economic policies and institutional development must correspond to the peculiarities and the state of development of each country, while at the same time steering the economy towards the fulfilment of socially desirable goals.

II. Recent economic trends and developments in the ESCWA region

A. The global context

8. The world economy continued to expand in 2005, although at a slower rate than the previous year. The United States of America represented the core of world economic growth, while Japan kept up its pace of economic recovery. The European economies showed robustness and stayed on a low but consistent economic growth path. China and India experienced another year of rapid economic growth. Both

countries' presence in the world economy became more visible in determining the demand factors for world flows of goods, services and capital.

9. The undercurrent of the present world economic expansion is held in balance by a rise in commodity and energy prices, including oil and oil-related products, and the high level of liquidity. Although the level of international liquidity has declined from that of the previous year, it remained historically high. The inertia of excess liquidity encompassed financial and real assets, particularly in the emerging markets of developing countries. In the ESCWA region, the bloated regional stock markets are experiencing a crash, which was anticipated in the previous issue of the *Survey*. In comparison with the rapid rise in asset prices, the prices of goods and services have been rising gradually, while high levels of commodity prices have consolidated.

10. As a region of major oil exporters, the ESCWA region benefited from the current global context. For the member countries of the Gulf Cooperation Council (GCC), the oil boom is well into its third year. For the non-oil-exporting countries in the region, this positive external environment sustained their economies in the face of a potentially vulnerable demand structure and ongoing security concerns.

B. Oil sector development

11. As world demand for oil and oil-related products continued to grow, tight supply-demand conditions continued into 2005. Crude oil prices were on a steeply increasing trend throughout the year. A representative brand (West Texas Intermediate (WTI) Cushing) of crude oil averaged US$ 56.6 per barrel in 2005. This is a significant increase from the US$ 41.5 per barrel of the previous year.

12. The near-maximum level of oil production in the ESCWA region continued in 2005, reaching 19.5 million barrels per day, with a slight increase of 2.3 per cent over its 2004 level. The lack of sufficient spare capacities has led to tight oil production in most countries in the region. With the exception of Iraq, the member States of the Organization of Petroleum Exporting Countries (OPEC) in the region (Kuwait, Qatar, Saudi Arabia and the United Arab Emirates) produced 4.7 per cent more than their average crude oil production in 2004. Among the non-OPEC member States in the ESCWA region, Egypt, Oman, the Syrian Arab Republic and Yemen continued to experience a decrease in oil production in 2005, a 2.9 per cent decline from the 2004 level.

13. Gross oil export revenue in the region was estimated at a total of US$ 307 billion in 2005, a 40.4 per cent increase over 2004. For 2006, two scenarios have been projected, relying on the assumption of high and low prices of a barrel of oil. With US$ 52 per barrel for the OPEC basket of crudes price scenario, oil revenues are projected to reach US$ 368 billion, while under a more optimistic scenario of US$ 57 per barrel, they would reach US$ 404 billion.

C. Output and demand

14. The recent global oil boom and high level of liquidity have underpinned strong growth in the ESCWA region. This led to still another good year in terms of overall economic growth; however, the detailed picture is still one of uneven development,

with the wealthy oil economies gaining momentum and the conflict-affected economies suffering from either the immediate effects of political upheaval or the aftermath thereof.

15. The emerging capital markets, stock markets in particular, created a leverage that linked external environments into domestic demands. Positive expectations dominated stocks and real estate markets during 2005. However, the economy as a whole is increasingly vulnerable to developments in stock and property markets. The signs of asset bubbles in the presence of weak regulatory frameworks became more evident in early 2006 and, as envisaged by many, including ESCWA, stock prices crashed in March by immense margins.

16. Gross domestic product (GDP) growth in constant 2000 prices in the ESCWA region (excluding ESCWA members Iraq and Palestine) stood at 6.3 per cent in 2005, compared with 6.4 per cent in 2004. Accordingly, the two ESCWA subregions (the more diversified economies and the GCC members) enjoyed another good year of high real GDP, as can be seen from the table below. Overall, GDP per capita in 2005 increased by an estimated 3.9 per cent, a drop from the 2004 growth rate of 4.2 per cent, which basically reflects the difficult standards of living within the zones in conflict. The region's population growth rate has remained more or less constant at the 2.4 per cent level over the past few years.

17. The fact that the short-term business cycle fluctuations in the region remain closely tied to developments in the oil market means that it will be difficult to make accurate predictions of future performance, especially when wealth intermediation through the poorly regulated stock market accentuates the volatility of the cycle. In a sense, the region's economy is becoming more volatile on account of oil price fluctuations and expectations built on bubbles in the stock markets that burst. Official GDP estimates of recent years in some ESCWA member countries were revised upwards, which suggests that the magnitude of the current boom is prone to misdiagnosis, particularly in the absence of reliable regional data. Nevertheless, should the current range in oil prices prove short-lived, economic expansion is forecast to taper off during 2006, with the overall GDP growth rate for all countries predicted to reach 5.4 per cent, a 1 per cent drop from the 2005 high growth rate.

18. Overall real GDP growth rates in the GCC members have hovered around 7 per cent during the past two years, whereas the per capita GDP rate remained at 3.9 per cent in 2005 compared with 4.0 per cent in 2004. The realization of the rent and wealth effect, the latter component leveraged through stock markets, was evident in this subregion, with sustained business and consumer confidence. The demand-led part of the economic expansion has benefited the non-oil private sectors, mainly in banking services, trade, and construction and real estate. Although the private sector has become increasingly sensitive to stock and property market developments at this stage, the lagged effect of public expenditures, together with the multiplier effect, will sustain domestic demand in 2006. In most GCC members, large public investment projects are planned, budgeted or being partly implemented. The growth rate of this subregion is forecast at 5.8 per cent for 2006, allowing for the effects of the financial markets' collapse of March 2006 on investment and growth.

Table

Annual average percentage change in GDP growth and inflation rates in the ESCWA region, 2002-2006

Country/area	Real GDP growth					Inflation rate[a]				
	2002	2003	2004	2005[b]	2006[c]	2002	2003	2004	2005[d]	2006[e]
Bahrain	5.2	7.2	5.4	6.2	6.3	(0.5)	1.6	2.4	3.3	1.6
Kuwait	(2.0)	12.7	16.3[f]	6.5	4.1	0.9	1.0	1.3	4.2	1.8
Oman	2.6	2.0	5.6	4.2	5.5	(0.7)	(0.3)	0.4	1.9	1.1
Qatar	7.3	5.9	8.7	7.6	8	0.2	2.3	6.8	8.8	2.7
Saudi Arabia	0.1	7.7	5.2	6.8	6	0.2	0.6	0.3	0.7	1.0
United Arab Emirates	3.0	12.2	7.5	8.0	6	2.9	3.1	4.7	5.4	4.5
Gulf Cooperation Council countries	1.1	8.7	7.2	6.9	5.8	0.8	1.3	1.8	2.7	2.0
Egypt	3.1	4.2	4.9	5.5	4.6	2.7	4.2	10.8	3.1	8.0
Jordan	5.7	4.1	7.7	7.3	5.6	1.8	1.6	3.3	3.5	8.4
Lebanon	(1.3)	3.0	5.0		3	4.3	3.0	2.4	1.9	2.0
Syrian Arab Republic	5.9	1.1	2.0	4.0	3	1.0	4.8	4.6	4.0	5.0
Yemen	3.5	3.8	3.9	4.6	4.2	12.2	10.8	12.5	5.6	11.4
More diversified economies	3.2	3.6	4.6	4.8	4.3	3.2	4.4	8.8	3.3	7.3
ESCWA region[g]	1.8	7.1	6.4	6.3	5.4	1.5	2.2	3.9	2.9	3.5
Iraq[h]	(6.9)	(33.1)	23.0	10.0	7	19.3	33.6	27.0	37.0	12.0
Palestine	(3.6)	(0.1)	2	4.9[i]	(0.8)	5.7	4.4	3.1	3.5	3.1
Total ESCWA region	**1.3**	**5.2**	**6.8**	**6.4**	**5.4**	**2.2**	**2.9**	**4.6**	**3.9**	**3.8**

Source: ESCWA, based on computations of growth rates from real GDP figures at constant 2000 prices. The latter are taken from national sources and official figures as provided by answers to questionnaires of the *National Accounts Studies of the ESCWA Region, Bulletin No. 25*.

[a] Subregional average inflation rates are weighted average, where weights are based on GDP in constant 2000 prices.

[b] ESCWA estimates, February 2006.

[c] ESCWA projections, February 2006.

[d] Estimates for 2005 based on official preliminary figures.

[e] International Monetary Fund, World Economic Outlook Database, September 2005. However, ESCWA estimates higher inflation rates generally, especially for Qatar.

[f] From official figures. It should be noted that the bulk value of the increase in official data was in mining and quarrying, and real value added grew by 34.9 per cent while oil output grew by 7.9 per cent only.

[g] Excluding Iraq and Palestine.

[h] Rates for Iraq are based on official sources except for 2005 and 2006, which are ESCWA secretariat estimates.

[i] Latest (February 2006) figures from the Palestinian Central Bureau of Statistics.

19. The subregion, comprising the more diversified economies, was able to maintain its gradual acceleration in economic expansion during 2005. Although some positive developments in the manufacturing sector were seen in Egypt and Jordan, this subregion's growth in the current positive cycle has continuously been

led by private consumption. Favourable external conditions, a high level of global liquidity, rapid growth in trade in such services as tourism, and a stable inflow of workers' remittances from abroad loosened those countries' foreign exchange constraints, which allowed demand expansion to take place at a rapid pace. Moreover, this positive external economic condition assisted Lebanon in avoiding a large decline in its economy in the face of a deteriorating security situation after February 2005. The subregion's real GDP growth rate recorded 4.8 per cent, the highest rate attained since 2000. Likewise, its overall per capita income soared to 2.5 per cent.

20. Security-related tensions persist in the conflict-affected economies. This situation will blight any prospects for socio-economic stability in Iraq and the Occupied Palestinian Territory, and has already led to negative per capita growth in the Occupied Palestinian Territory, as well as inducing widespread poverty. Continued armed attacks on an already weak oil infrastructure and other deteriorating security conditions in Iraq led to a decrease in oil production in 2005. Consequently, Iraq failed to sustain the pace of economic recovery witnessed in the previous year. Its real GDP growth in 2005 was estimated at 10 per cent, lower than the 23 per cent recorded in 2004. Likewise, Iraq's per capita GDP declined to 7.1 per cent from 19.6 per cent in 2004. The Palestinian economy experienced weak economic growth in 2005. Real GDP growth in Palestine was estimated at 4.9 per cent in 2005, up from 2 per cent in 2004; GDP per capita growth was 1.6 per cent in 2005 after negative values for the previous three years. The slowdown in economic growth can be attributed to closures by the Government of Israel through the imposition of the "separation wall", which has impeded labour and trade flows. Living standards are expected to remain below potential in both economies unless the political situation stabilizes with active international support.

D. Costs and prices

21. Both external and internal factors spurred rising prices in the ESCWA region. Import prices in petroleum products and other commodities increased, while internally the rising rents stemmed from the hike in asset prices that affected general price levels, particularly in the GCC countries. The average official inflation rate for the ESCWA region was 4 per cent in 2005, although it should be noted that the weighting system of the consumption bundle in many member countries does not fully reflect the actual rise in prices. Within the ESCWA member countries, "official" inflation rates ranged from a low of 0.7 per cent in Saudi Arabia to a high of 8.8 per cent in Qatar, with the exception of Iraq, which experienced an inflation rate estimated at 37 per cent.[1] In Egypt, average inflation rates declined from 10.8 per cent in 2004 to a mere 3.1 per cent in 2005. This is mainly due to the real appreciation of the domestic currency against the United States dollar and the increased effectiveness with which monetary authorities have been able to control liquidity. In Iraq, serious energy shortages and a reduction of energy supplies drove up average prices at end-2005 while the reduction of energy subsidies late in 2005 further spurred inflation during the first quarter of 2006.

[1] For an overview of the estimated inflationary gap in the ESCWA member countries, see the *World Economic Situation and Prospects 2006* available at http://www.un.org/esa/policy/wess/wesp.html.

E. Labour markets

22. Economic growth was unable to make a dent in the region's high unemployment rate, especially the high rate of unemployment among young people, which has led to feelings of despair. The labour market in the ESCWA region is experiencing a glut, due mainly to the high rates of new entrants and low job creation. Although regional labour market statistics are sketchy, high unemployment rates remain a serious concern, with estimates of unemployment hovering at the double-digit level in most ESCWA member countries.

F. External sector

23. The total gross value of merchandise exports, including re-exports, of ESCWA member countries in 2005 was estimated at US$ 462 billion, while the total gross value of merchandise imports was estimated at US$ 273 billion. The GCC members account for 87 per cent of those exports and 71 per cent of total imports. Oil and oil-related products continued to be the major export product group of the ESCWA region. Despite the current rise in oil prices, in 2005 the share of oil exports in total exports, 65 per cent, barely changed from the previous year. It is evident that non-oil exports were growing at the same rate as oil exports. Among others, the apparel sector in Jordan and the steel sector in Egypt became established as export revenue earners for their respective countries.

G. Economic policy developments

24. Long-term development priorities require active fiscal expansion, which is at odds with the current short-term stabilization measures. However, in view of the rapid rise in domestic asset prices and inflationary pressures from external factors, Governments must re-engineer their fiscal policies to attenuate the speculative impact and possible downswings in domestic demand levels. The Governments of the GCC countries shifted their fiscal stance to a more active one, though still within the limits of prudential fiscal management. The Governments in the more diversified economies were continuously at their fiscal ceiling, and prioritization within their fiscal constraints became more difficult, particularly in view of the rise in energy prices.

25. The central banks of the GCC countries warned of possible "asset bubbles" and, in addition to increasing interest rates in parallel with the United States Federal Reserve, other monetary measures, such as restrictions on lending for speculation and open market operations, have been taken to contain excess liquidity. However, the difficulties lay in the nature of selective demand management during the boom period, which proved difficult, and the effect of the measures was limited. The inflexibility in policy stemmed from the pegging of these countries' national currencies to the United States dollar. Central banks in the more diversified economies successfully managed their foreign exchange position, albeit without much impact on domestic demand.

26. The *Survey* notes that rights-based strategies require the regulation of the capital and financial accounts of the balance of payments. Capital account liberalization can be highly destabilizing for the poor and middle-income countries in the ESCWA region. Unbridled capital account liberalization fosters the

accumulation of excessive foreign debt, promotes speculative capital flows that finance consumption more than investment, increases a country's vulnerability to balance of payments crises, and facilitates capital flight. In spite of the conventional insistence on capital account liberalization, this strategy does not contribute to macroeconomic stability and, even if it does raise the economic growth rate in the short term, this effect tends to disappear in the medium term. In this context, balance of payments instability can be especially damaging for the poor.

H. Prospects

27. The ESCWA member countries tend to be net food importers, which is one key reason for their balance of payments constraints. Climatic and geological features strongly limit the availability of natural water in several countries, and impose high costs on agricultural production, which, in turn, contributes to poverty, especially in the countryside. These difficulties are made worse by the inefficiency of delivery mechanisms and the high levels of water wastage in several countries. The combination of natural factors, oil price volatility and geopolitical tensions explains why the human development performance of the ESCWA member countries has been less than satisfactory. It also helps to put into context the rigidity of economic, social, political and institutional structures, the structural insecurity, and the difficulty of reforming policies in order to achieve economic growth, stability and rights-based development. These reforms will remain essential even if the current oil boom proves lasting. The current social, economic and institutional structures are conducive to capital leakages and destabilizing bubbles in real estate and equity markets, both in the oil economies and in the more diversified economies. In order to achieve sustainable growth and economic diversification, reduce unemployment and support rising living standards, as part of a rights-based development strategy, a significant volume of additional resources needs to be deployed within an industrialization strategy for the region. In addition to this, the countries of the region urgently need to consider their future after the exhaustion of oil and/or its rents.

III. A rights-based, pro-equity macroeconomic framework

28. The main objectives of the policies outlined in the *Survey* are as follows. First, it is important to increase the degree of coordination across different policy areas in the ESCWA region, including industrial, trade, monetary, financial and exchange rate policies. Secondly, it is crucial to restrict the openness of the capital account of the balance of payments in the countries in the region, in order to expand the policy space available to the regional Governments. Thirdly, the fiscal space available to ESCWA member countries should be expanded in order to facilitate the mobilization of the existing rent flows and maximize future growth, in order to pursue socially desirable goals. Fourthly, productivity of resources in the ESCWA region must be increased, and there must be limits on the ability of elite-driven financial systems to control domestic credit, the financing of the State and the balance of payments. These policies can contribute to the achievement of rights-based development objectives and are urgently needed, because failure to shift economic strategies at this relatively favourable moment, with high oil prices, may lead not only to further capital flight, but also to macroeconomic instability. More important, a failure to act

would squander a rare opportunity to achieve important objectives at a relatively low cost.

29. The choice between mainstream and rights-based fiscal and monetary policies involves not only their internal consistency, but also the political constraints influencing the selection of economic policy in each country. More specifically, the most important constraint hindering the introduction of pro-poor strategies in many ESCWA member countries is not resource scarcity or the lack of government capacity. Rather, it is the lack of political will to confront the internationally dominant conventional policy consensus and build alternatives based on the collaborative efforts of national Governments, private capital and civil society.

30. A pro-equity macroeconomic framework for the ESCWA region should include three goals. It should: (a) keep the growth rate well above the rate of population increase; (b) substantially reduce the variability of growth; and (c) foster a more equitable and employment-friendly growth path. The simplest element to specify is how to raise the growth rate. Setting aside exogenous factors such as the effects of political instability, the major limitations to faster growth are: (i) restrictive fiscal policy; (ii) contractionary monetary policy; (iii) low rates and poor quality of investment; and (iv) in some countries, a balance of payments constraint. For the purpose of this summary, only the major issues raised in fiscal and monetary policies are outlined below.

A. Fiscal policy

31. Converting a restrictive fiscal policy to an expansionary one could be achieved through an employment-intensive public investment programme to expand the physical and social infrastructures, financed by oil rents or borrowing, increased development assistance and debt relief. A growth-accommodating monetary policy requires using the interest rate as a long-term investment instrument rather than for short-term stabilization; which means a relaxation of inflation-targeting be it explicit or implicit. For non-oil exporters, the balance of payments constraint could be relieved by interventions to establish a stable and moderately undervalued real exchange rate. Also for the more diversified economies, GCC development assistance could provide support during the transition towards a stronger export performance.

Current pro-cyclical fiscal and monetary policies

32. The fiscal and monetary policies in almost all stabilization and structural adjustment programmes have been pro-cyclical, when they were not continuously contractionary, exacerbating the world market factors that destabilize the ESCWA region. Reversing this policy is not a simple matter of increasing expenditure. A growth-fostering pro-equity fiscal policy package requires more public expenditure of a particular type: well-conceived public investment, which can achieve the three necessary elements of such a package, including (a) demand expansion; (b) supply enhancement; and (c) redistribution. In the absence of a robust public investment programme, the pro-equity element in fiscal policy would consist of social expenditure, counter-cyclical measures and progressive taxation. While each of these is important, in many developing countries the capacity of ESCWA member countries to intervene counter-cyclically is limited.

33. More important, basing redistribution on the current budget is not a growth strategy. If sustained, it may create a new, more equal distribution towards which the economy will move. However, except for a possible one-off impetus resulting from the positive incentives to the poor of the redistribution, it has little impact on the sustainable growth rate. For this reason, well-conceived public investment is the sine qua non of a pro-equity growth strategy, and the reduction of public investment undermines that strategy.

Public versus private investment

34. The emphasis placed on public investment requires consideration of one of the major arguments against it, so-called crowding out. The argument that public investment in the ESCWA region would crowd out private investment is somewhat unfounded. It is typically the case that those who make this argument also urge Governments to undertake major policy changes to encourage inflows of foreign investment, usually without expressing strong concern that the latter might crowd out private domestic investment. It is recalled that crowding out occurs when an economy is near full employment. When there are unutilized resources, there is economic space for an increase in all types of expenditure, both public and private. Even if crowding out occurs under full employment, it is unlikely to be complete. As a consequence, public investment would be growth-inducing, both in its demand and capacity effects, unless the return on the marginal private component was higher than the return on the public component by an amount that would make the impact on growth negative.

35. Crowding out due to the introduction of public investment will reduce the rate of growth if — and only if — public investment is more capital-using than private investment. If the capital-output ratio for public investment is smaller than for private investment, public investment never reduces the growth rate. If crowding out is total, the growth rate falls only if public investments are more capital-using than private ones. Thus, public investment causes a negative impact on the capacity-creating source of growth only under very restrictive conditions in which crowding out is total and private investments use less capital per unit of output, which is empirically not the case in the ESCWA region. The former condition is unlikely, and the latter can be avoided by public choice of investment projects. In addition, employment-intensive public works that have already been implemented can provide practical guidelines to ensure that some public investments are not excessively capital-using.

36. What is more pertinent to the ESCWA region crowding-out case is that a substantial part of private sector investment in the region either does not borrow for investment, or does not do so in the financial markets that would be affected by government borrowing. Investment by small producers, rural and urban, is often self-financed, or financed from indigenous lenders with little connection to the formal banking system. Foreign investment, to the extent that it is important, is not typically financed from domestic financial markets.

37. Targeted public investment into pro-poor areas can boost aggregate demand (potentially sparking the recovery of a stagnant economy), loosen the supply constraints on long-term growth and help the reallocation of resources to achieve poverty reduction objectives, especially in economies operating below potential, as is the case in most ESCWA member States. There is empirical evidence in the

region indicating that public investment generally "crowds in" private investment in upstream and downstream sectors (for example, supplies of inputs and consumables, cleaning, maintenance and security services, trading and finance, and workforce training). Public investment can also support private investment and output growth if it expands a country's physical infrastructure (roads, ports and airports, water, sewerage and irrigation systems, electricity-generating capacity and transmission lines), boosts labour productivity (in particular, through public education and training programmes, public transport or public health provision), or if it fosters private savings. When public investment falters, aggregate profits decline, reducing both the incentives and the resources available for private investment. Public investment can also support quality foreign investment. Evidence also shows the following: first, that public investment has played a key role in fostering growth and reducing poverty in several dynamic economies, especially in East Asia; and second, that when public investment declines, private sector profitability often declines, reducing the resources available for investment. In this sense, adequate levels of public investment can be essential for sustained pro-poor and rights-based growth, especially in the resource-constrained more diversified economies in the ESCWA region.

More proactive economic policies

38. In order to support economic stabilization and large public investment programmes, the Governments of the region's more diversified economies need to discard the excessively restrictive fiscal policy stance imposed by conventional economic strategies and adopt more proactive policies. This is not necessarily inflationary: in the ESCWA region, there is no evident relation between fiscal deficits, growth, unemployment and inflation. In other words, public investment programmes can be deficit-financed, as long as these deficits are not excessive, the economy is operating below capacity, the balance of payments constraint is not binding, and the deficits can be financed in a sustainable manner (if the additional domestic debt of the public sector can be paid off by the tax revenues generated by future growth). However, if the Government needs to monetize its deficit because, as in most ESCWA member countries, the financial markets are insufficiently developed, or because debt finance may have adverse distributive implications, care must be taken to limit the ensuing expansion of demand because of its potentially adverse implications for inflation and the balance of payments. Even though this is reassuring, it is better to err on the side of stability rather than to generate unsustainable disequilibriums, especially in view of the large social and investment programmes required by a pro-poor growth strategy in the ESCWA region. Experience indicates that if public deficits are used to finance investment that expands aggregate supply, and as long as they are financed in a sustainable fashion, their impact should not be unduly inflationary either in the short or the long term.

Pro-poor investment

39. Pro-poor public investment in the ESCWA region should target the following priority areas: (a) infrastructure provision; (b) rural and urban slum area development; and (c) education and health. In most ESCWA member countries, it is especially important to support the development of agriculture and its linkages with other economic sectors for three reasons: (i) its current economic importance; (ii) the fact that large numbers of poor people live in rural areas; and (iii) the potentially

severe dislocations to labour and agricultural production due to trade liberalization. The more diversified economies in the ESCWA region can draw upon the Chinese, Indonesian and Vietnamese strategies implemented between the 1970s and the 1990s, as they attempt to raise agricultural productivity, boost the links with agriculture and other dynamic economic activities and increase the scope for the production of exportable goods. In order to do this, it may be necessary to transform significantly the land tenure systems in these countries and invest heavily in better technology and in physical and social infrastructure, including better seeds and fertilizers, improved crop selection, irrigation, storage and transport facilities. Public investment in rural development, especially in the Mashreq region, can focus on the diversification of agriculture into labour-intensive high-value agricultural commodities such as horticulture and livestock for increased profit incentives and employment opportunities. Labour-intensive development programmes for urban slums should also be fostered in view of the large degree of urbanization in the more diversified economies.

40. The expansion of low-productivity small-scale labour-intensive sectors, such as family agriculture and small and medium-sized enterprises, in urban areas is unlikely to deliver the employment and productivity growth required for the long-term success of a pro-poor development strategy. These sectoral initiatives must be plugged into broader programmes of education, training, technological development and labour transfer to high-productivity sectors, in order to deliver higher productivity and better living standards for the poor.

41. Another priority area for public investment is technological upgrading, especially in the manufacturing industry. The ESCWA member countries need to upgrade their productive capabilities because productivity gains are the key to sustained growth and rising incomes in the long run. These gains can be achieved in at least two different ways. One is the development of mass production facilities where low-paid unskilled workers engage in repetitive tasks at high speed in traditional plantations, or in manufacturing industries producing clothing, shoes or established electronic products, as in the *maquiladoras* in Mexico or in most Asian export-processing zones. Alternatively, better-paid skilled workers could be expected to work cooperatively and apply more sophisticated technical skills in the service industry, in specialized agricultural production or in the manufacture of relatively sophisticated electronic goods, chemicals and machines. Obviously, most ESCWA member States cannot move directly into these advanced production processes because they lack the technology, infrastructure, skills, managerial capacity and finance to do so. However, this type of development is precisely that which rights-based and pro-poor strategies should aim for, even if they are achievable only in the medium and the long run, and only in certain areas of the economy. They should serve as a growth engine that pulls other sectors and labour forces forward.

42. The final priority area for public investment is the promotion of non-traditional exports. The literature on industrial policy shows that the expansion of exports can make an important contribution to productivity growth because it exposes producers to the stringent test of foreign market access. Export growth is also essential for the generation of healthy trade surpluses and the accumulation of foreign currency reserves, which will support the stabilization of the exchange rate in the more diversified economies. In the absence of sizeable currency reserves obtained through trade surpluses, the more diversified economies will always be

compelled to seek less desirable forms of international finance, especially aid and portfolio capital inflows, or borrow from the international financial institutions, whose conditionalities might limit their ability to pursue rights-based policies. Export growth in the medium and long run requires a competitive and stable real exchange rate, as well as coordinated industrial policy initiatives to develop a country's competitive advantages in strategically important sectors. The Government will need to become involved in the complex task of choosing the right sectors and encouraging private investment therein, a challenge which has been addressed successfully by several countries in East Asia and elsewhere over long periods of time.

Financing through taxation

43. The ESCWA secretariat suggests that these policy priorities be funded primarily by local (national or regional) sources. Raising resources locally to support a rights-based development strategy will require a concerted effort since, in many ESCWA member States (not necessarily the poorest), the retained portion of savings and tax revenues are insufficient to support ambitious pro-poor programmes. Private sources of finance will require support from additional public sector spending. These additional expenditures should be financed primarily by taxation rather than debt. In most ESCWA member countries, there is a large untapped potential for raising taxes, since tax ratios are often markedly below 20 per cent of GDP. In most countries, taxation is almost exclusively based on indirect taxes (including taxes on oil), which helps to consolidate the inequalities that currently structure these economies. Some GCC countries levy no income tax at all, and enforcement across the region tends to be so lax that the equalizing impact of taxation is often even more limited than it initially appears to be. In addition to this, a large part of the taxes that are actually collected tend to be wasted from the point of view of their pro-poor impact because of regional political instability factors. Countries including Jordan, Oman, the Syrian Arab Republic, the United Arab Emirates and Yemen allocate at least a quarter of their central government budgets to defence spending. In fact, there tends to be a systematic pattern of substitution between defence and social spending.

44. Achieving the required levels of sustainable public spending will require significant modernization and expansion of the tax systems of ESCWA member countries, as well as improvements in tax collection and administration, in order to raise additional revenues and improve the distributive impact of taxation. Tax revenues play a fundamental role in the mobilization of resources for the allocative, distributive, growth and stabilization functions of the State, especially in countries with weak financial systems. Investment in tax collection and administration can bring high returns to the Government, and a pro-poor tax system will play an essential role in supporting the improvement of social welfare in the long run. In order to fund growth-accommodating and pro-poor fiscal policy and distribute income while maintaining macroeconomic stability, most ESCWA member States will need higher and mildly more progressive tax rates, including a shift away from indirect taxation and towards direct (progressive) taxation. It will also be necessary to expand the tax base through the taxation of wealth, large or second properties in rural and urban areas, unearned incomes (especially interest and capital gains), financial transactions and international capital flows. The most important constraint on the expansion of the tax base in the ESCWA region is not economic or

managerial (although these obstacles are relevant, especially in economies with large informal sectors), the constraint is primarily political. However, domestic pressures for economic privileges or threats of capital flight should not prevent the State from mobilizing domestic resources, especially when they are based on rents.

B. Monetary policy

Inflation targeting

45. Perhaps the most concrete application of the price-determined, as opposed to demand-determined, framework manifests itself in the policy of "inflation-targeting". Within this framework, every economy is presumed to be in, or moving towards, general equilibrium, and inflation is the result of expectations and "random shocks". In other words, inflation has no structural cause; it follows from people's anticipation of it, and this anticipation is primarily the result of government behaviour. In its most inflexible form, inflation-targeting involves assigning to the central bank the mandate to use its policy instruments to realize an inflation rate below a specific rate. The instrument used to "hit" the target is almost always the nominal interest rate. In the practices of ESCWA member States, attempting to fulfil such a mandate overrides all other policy objectives, be they short-, medium- or long-run; it means achieving a competitive exchange rate, stimulating investment, and managing the budgetary cost of the Government's debt.

46. The prevailing argument in the ESCWA region in favour of inflation-targeting is that its success, a low inflation rate with a small variation, would foster growth by providing a stable macroenvironment for private investment. There are two issues here: the effect and wisdom of targeting as such, and the inflation rate to be targeted. It can be pointed out that consideration of the alleged positive benefits of inflation-targeting requires a prior acceptance that the policy is feasible, that is, that most central banks in the region could, by use of the monetary instruments available to them, realize a predetermined rate of inflation and maintain it with small variability. This proposition is not credible, however, because of the large and unavoidable random "shock" (namely in oil prices) element in policy outcomes in the ESCWA region.

47. Despite the recessionary consequence of choosing a low numerical target and attempting to achieve it in the context of severe random oil shocks, many external assistance agencies vigorously defend the policy for inflation reduction as such. What might be called the "bottom line" defence is that "inflation is bad for the poor"; therefore, inflation-targeting is "good for the poor". A cursory review of the data on the country level shows that there is little evidence to support this in the ESCWA region. Other empirical studies of the distributional impact of inflation found that "though in high inflation countries restrictive monetary policy is often beneficial for inequality, reducing inflation in economies with initially low inflation might increase inequality".[2]

48. Rights-based anti-inflation programmes in the ESCWA region recognize the costs of inflation for the poor, in terms of their income levels and the distribution of

[2] Rossana Galli and Rolph van der Hoeven, "Is inflation bad for income inequality: The importance of the initial rate of inflation", Employment Paper 2001/29 (Geneva, International Labour Office, 2001).

income, as well as the costs for the poor of the traditional inflation stabilization strategies. They should also take into account empirical evidence showing that stable moderate inflation may have no adverse macroeconomic consequences, and that the obsession with very low inflation can be bad for the poor because it is associated with slow growth, high unemployment and high interest rates for long periods. None of these arguments indicates that inflation is "good". Rather, the arguments highlight the fact that there may be choices to be made about the priority and intensity to be given to inflation control. These are not simply "technical" issues, and the benefits of very low inflation do not necessarily trump every conceivable alternative, every time.

Need for coordination of policies

49. Rights-based anti-inflation policies in the ESCWA member countries should involve a broad range of policies deployed in close coordination, including fiscal, monetary, income, price, industrial and exchange rate policies. In contrast, the strategies practised tend to rely primarily on one or two relatively blunt policies, in particular fiscal austerity and interest rate manipulation. This difference arises because rights-based anti-inflation policies address the causes of structural (long-term) inflation which, especially in the more diversified economies in the ESCWA region, tends to be located on the supply side of the economy. In contrast, inflation in the oil economies tends to be closely correlated with their balances of payments. Mainstream anti-inflation strategies focus on the monetary symptoms of inflation and its propagation mechanisms, leading to their almost exclusive policy focus on the demand side of the economy. However, addressing the causes of inflation normally requires an ample set of economic policy tools, backed up by negotiations to coordinate sectoral income demands and defuse the existing distributive conflicts. Rights-based anti-inflation policies should also seek to promote the Government's long-term growth and equity objectives, rather than subordinating all State policies to the goal of inflation stabilization. The combination of a wide variety of policies and the protection of the pro-poor goals of Governments can facilitate the involvement of society in the pursuit of low and stable inflation. This is essential because, in the absence of a broad-based commitment to macroeconomic stability, the Government would have to deploy imperfect instruments with insufficient information, possibly against unwilling social sectors, in order to impose its objectives upon society. This would increase the cost of inflation control and, in all likelihood, reduce the welfare of the majority.

50. In summary, low inflation can be achieved at an acceptable social cost, but this requires more than controlling public spending, limiting the supply of money or jacking up interest rates. Low and stable inflation is the outcome of long-term economic development and a social commitment to price stability, which should be part of a rights-based development compact in the ESCWA region. Social cooperation and policy coordination can foster an environment in which society is committed to low inflation, where economic patterns of behaviour are broadly compatible with this objective and where government policy contributes directly to this outcome. This will reduce the scope and the need for central bank discretionary action, especially arbitrary changes in interest rates that can create uncertainty, deter investment, generate unemployment, and impose obstacles to the achievement of pro-poor objectives such as the Millennium Development Goals. In a pro-poor policy framework, inflation control is not the province of a single government

institution such as the central bank or the ministry of finance; it is a strategic national objective that will support the achievement of rights-based development.

51. The structural characteristics of ESCWA member States make mandated targeting either unfeasible or undesirable, or both. What is both feasible and desirable would be a political commitment to poverty reduction, with each aspect of macroeconomic policy assessed ex ante and ex post for its poverty impact, and with these assessments subject to public scrutiny. One manifestation of the commitment could be a poverty assessment of the annual budget.

C. Conclusions

52. Liberated from the straitjacket of tight inflation-targeting, monetary policy could contribute to pro-equity growth. Used as the major instrument for macroeconomic management, monetary policy can do little to make growth pro-poor. However, in support of an expansionary fiscal policy it can indirectly foster growth that is pro-poor. As a general rule, if inflationary pressures are weak, this support would take the form of positive but low real interest rates and an expanding monetary supply. However, interest rates should not be so low as to induce high capital-intensity in future output.

53. While these guidelines appear simple, their application in Western Asian countries is not straightforward. In all the countries in the region, financial markets are underdeveloped, though some exhibit certain forms of financial intermediation. The concrete result of underdeveloped financial markets and conditions of regional instability is that Governments find it difficult to sell their bonds to private agents. This explains the common practice in the region of legislation that requires commercial banks to hold a portion of their reserves in government bonds. In practice, this requirement has tended to have an anti-poor bias, because it redistributes general revenue to the wealthy as interest payments.

54. Narrow financial markets imply that the effectiveness of monetary policy to pool savings, stimulate private investment and influence/guide its allocation patterns is low. However, the limited ability of the central bank to stimulate investment does not imply that there is no pro-equity role for the central bank rate. Lower central bank rates would have two pro-equity effects: (a) government bonds are held by the wealthy, or the institutions of the wealthy, so lowering rates would have a positive impact on income distribution; and (b) lower rates imply a smaller domestic debt service in the public budget, producing "fiscal space" for pro-equity government expenditure.

55. Allowing the money supply to expand moderately faster than real output can also have a pro-equity impact, by increasing access to credit in "informal" financial markets. It also encourages financial "deepening", that is, the ratio of the money supply to aggregate output, which is typically low in the ESCWA region. Money supply management raises the question of what instruments would be used to counter inflationary pressures if these became a serious policy concern. The key policy issue is what constitutes a "serious concern". Cross-country regressions suggest that inflation is uncorrelated with growth for the rates that characterize the ESCWA region. Therefore, if growth and poverty reduction are the goals, a tolerance for moderate inflation is required. This is especially the case because,

owing to the weakness of financial markets, the only effective instrument for reducing inflation in most countries would be fiscal contraction.

56. In summary, a pro-equity monetary policy requires low real interest rates, a tolerance for moderate inflation rates, and an expansion of the money supply that accommodates growth and financial deepening. To achieve these outcomes when private banks set exorbitant interest rates, it probably would be more pro-equity to finance prudent fiscal deficits by monetization rather than by bond sales, which redistribute income to the wealthy.